

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF BIG RIVERS ELECTRIC)	
CORPORATION, LOUISVILLE GAS AND)	
ELECTRIC COMPANY, WESTERN KENTUCKY)	
ENERGY CORP., WESTERN KENTUCKY)	
LEASING CORP., AND LG&E STATION TWO INC.)	CASE NO. 97-204
FOR APPROVAL OF WHOLESALE RATE)	
ADJUSTMENT FOR BIG RIVERS ELECTRIC)	
CORPORATION AND FOR APPROVAL OF)	
TRANSACTION)	

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O R D E R

BACKGROUND

On June 30, 1997, Big Rivers Electric Corporation ("Big Rivers") and the LG&E Parties¹ (collectively referred to as "Applicants") filed an application requesting the Commission to approve or declare nonjurisdictional numerous rate, financing and operating agreements that are an integral part of Big Rivers' efforts to implement the First Amended Plan of Reorganization ("Reorganization Plan") approved by the U.S. Bankruptcy Court in Big Rivers' Chapter 11 proceeding. These agreements provide for a long-term lease of Big Rivers' generating units to WKEC, reduced wholesale rates for

¹ The LG&E Parties are wholly-owned subsidiaries of LG&E Energy Corp. ("LEC"). The subsidiaries which are co-applicants with Big Rivers are Louisville Gas and Electric Company ("LG&E"); Western Kentucky Energy Corp. ("WKEC"); Western Kentucky Leasing Corp. ("Leaseco"); and WKE Station Two Inc. ("Station Two Subsidiary"), formerly known as LG&E Station Two Inc. In addition, LG&E Energy Marketing Inc. ("LEM"), formerly known as LG&E Power Marketing Inc., is a party to numerous agreements making up the proposed transaction.

Big Rivers' four member distribution cooperatives, and the financings necessary to effectuate a restructuring of Big Rivers' debts.

The Applicants requested a declaration from the Commission that implementation of the Reorganization Plan does not constitute a transfer of ownership or control over Big Rivers within the meaning of KRS 278.020(4) or 278.020(5). In the alternative, they requested that if the Commission determines that there is a transfer of control within the meaning of the statute, that the Commission approve the transfer of control, as implemented through a series of Reorganization Plan documents.² Approval was also requested of a Transmission Service and Interconnection Agreement, including to the extent required, Big Rivers' Open Access Transmission Tariff, which is to be filed at the Federal Energy Regulatory Commission ("FERC"). The Applicants have filed in this case numerous versions of the Reorganization Plan documents, as well as the corresponding tariffs which reflect the provisions of those documents.

In summary, the proposed transaction is structured into two phases. Under Phase I, WKEC will operate and maintain the Big Rivers' generating units, Big Rivers will sell all power generated to LEM, and LEM will resell to Big Rivers power sufficient to meet its wholesale obligations. All power not resold by LEM to Big Rivers can be sold by LEM for its own account. Leaseco will purchase from Big Rivers the generation-related

² The Reorganization Plan documents include the Participation Agreement; the Facilities Operating Agreement; the Cost Sharing Agreement; the Power Purchase Agreement; the Lease and Operating Agreement; the Mortgage and Security Agreement; the Guarantee Agreement; the Nondisturbance Agreement; and the Tax Indemnification Agreement. See Application, at 14-15.

inventory³ at its fair market value, all personal property at its net book value, and will be assigned certain intangible assets.⁴ After necessary federal regulatory approvals are received, and prior to or contemporaneously with the commencement of Phase II, Leaseco will be merged with and into WKEC.

In Phase II, WKEC will lease Big Rivers' generating facilities for a 25-year term, perform all necessary operations and maintenance services, and sell the output of the generating facilities to LEM. WKEC will be an Exempt Wholesale Generator ("EWG") in accordance with Section 32 of the Public Utilities Holding Company Act of 1935 ("PUHCA") and its wholesale sales of power will be under the exclusive jurisdiction of FERC.

Station Two Subsidiary will subcontract with Big Rivers to perform operations and maintenance services for the Henderson Municipal Power & Light ("HMP&L") Station Two facility, and Big Rivers will assign to Station Two Subsidiary certain of its rights and obligations under contracts with HMP&L for operation of HMP&L's Station Two facility. Big Rivers' wholesale power supply contracts with its four member cooperatives will be revised, as well as the member cooperatives' retail contracts with the aluminum Smelters.⁵

³ Included in this inventory is all of Big Rivers' fuel and scrubber reagent, spare parts, SO₂ emission allowances, and all materials and supplies held for use in conjunction with the operation of the generating facilities.

⁴ Intangible assets include real property leases, equipment leases, permits, and contracts used in connection with the operation of the generating facilities.

⁵ The aluminum smelters are the Southwire Company and NSA, Inc. ("Southwire") and Alcan Aluminum Corporation ("Alcan").

The Reorganization Plan further provides that Big Rivers will contract with LEM to purchase power from LEM, at levels sufficient to cover all of the anticipated needs of Big Rivers' members. Big Rivers' outstanding debt with the Rural Utilities Service ("RUS"), formerly the Rural Electrification Administration, has been restructured and the current credit providers for Big Rivers' pollution control bonds have been replaced by new credit providers. Once the necessary approvals for the Reorganization Plan have been secured, Big Rivers will be out of the generating business while retaining its wholesale supply, transmission, and planning functions.

Big Rivers requested authority to implement on an interim basis rate reductions for wholesale electric service commencing on September 1, 1997 and continuing through the earlier of the closing date of the proposed transaction or August 31, 1998. The rate reductions proposed in Big Rivers' interim rates mirrored those of its proposed permanent rates. The Commission, by Order dated August 29, 1997, suspended the interim rates for one day and allowed them to become effective subject to change for service rendered on and after September 2, 1997. The Commission also determined that the approved interim rates should remain in effect only until issuance of a final rate Order determining the reasonableness of the proposed permanent rates.⁶

The Commission received requests for and granted intervention to the Office of the Attorney General ("AG"), Southwire, Alcan, Green River Electric Corporation ("Green River"), Henderson Union Electric Cooperative Corporation ("Henderson Union"), Jackson Purchase Electric Cooperative Corporation ("Jackson Purchase"), Meade

⁶ Case No. 97-204, Order dated August 29, 1997, at 4.

County Rural Electric Cooperative Corporation ("Meade County"), Chase Manhattan Bank ("Chase"), Bank of New York, Commonwealth Industries Inc., Willamette Industries Inc. ("Willamette"), PacifiCorp Power Marketing Inc., and the Kentucky Association of Plumbing, Heating and Cooling Contractors, Inc.

Informal conferences were held at the Commission's offices on July 16, 1997, October 8, 1997, and February 4, 1998. Public hearings were held on November 18 - 24, 1997 and March 18, 1998. Initial briefs were filed on January 30, 1998 with reply briefs filed on February 13, 1998. Supplemental briefs which were limited to the "unforeseen cost" issue were filed on March 30, 1998, with supplemental reply briefs filed on April 6, 1998.

HISTORY

Big Rivers is a rural electric cooperative utility, organized pursuant to KRS Chapter 279, which provides generating and transmission services to its four owner members. Each of its members is a rural electric cooperative utility engaged in the distribution of electricity and collectively they serve 91,500 customer members in 22 western Kentucky counties.

Big Rivers began experiencing financial problems in the mid-1980's shortly after completing construction of its newest generating station, the Wilson Generating Station ("Wilson"). Those problems were precipitated by a number of factors, including the relatively high cost of Wilson, a significant reduction in load growth, and claims by the Smelters that any rate increase would render their operations noncompetitive in world markets and drive them out of business. Big Rivers was eventually able to negotiate a debt

restructuring agreement with its creditors which the Commission approved in 1987 along with higher rates for all customers, including new rates for the Smelters which varied with the price of aluminum.

The revenue levels necessary to satisfy Big Rivers' debts as restructured in 1987 could not be achieved solely from power sales to its four member cooperatives. Rather, additional revenues needed to be generated each year through the sale of increasing levels of power to non-member wholesale customers. Unfortunately, the wholesale market for power was soft during this time and Big Rivers' sales efforts were unsuccessful in producing the revenue levels necessary. By the early 1990's Big Rivers recognized that it would soon be in a default position and it began discussions with RUS on the need for further debt restructuring.

Big Rivers' fortunes also changed from bad to worse during this period with the criminal and civil investigations and trials involving bribes and kickbacks in connection with its coal contracts and a former general manager. In an effort to find a long-term solution to its mounting financial problems, Big Rivers hired a "turn-around" specialist to advise and assist management in pursuing available business options. This action led to Big Rivers' solicitation of business offers and the eventual decision in early 1996 to pursue a business arrangement with PacifiCorp Holdings, Inc. ("PacifiCorp"). Under the terms of that transaction, a subsidiary of PacifiCorp would lease Big Rivers' generating units for 25 years and sell back to Big Rivers certain quantities of power at pre-established prices. While negotiating the terms of this transaction, Big Rivers was also negotiating with its major creditors to achieve a consensual restructuring of its debts and with its system's two largest retail customers, two aluminum smelters, to achieve long-term rate reductions and rate

stability. When its efforts to achieve a consensual debt restructuring were unsuccessful, Big Rivers filed on September 25, 1996 a petition for reorganization under Chapter 11 of the Bankruptcy Code.

Big Rivers' Plan of Reorganization, as originally filed with the Bankruptcy Court on January 22, 1997, included the lease transaction with PacifiCorp and lower electric rates that had been negotiated with the two smelters, one large non-smelter industrial customer and the four member cooperatives. The following month the Bankruptcy Court initiated an auction process to determine whether the PacifiCorp lease was providing maximum value to the Big Rivers' estate. The only entity to submit a bid in this process was LEC, and on March 19, 1997 the Bankruptcy Court accepted LEC's lease proposal on the basis that it would provide greater value to the Big Rivers' estate.

Big Rivers' Plan of Reorganization, as amended, which now included a lease transaction with subsidiaries of LEC and the lower rates previously negotiated with certain customers, was approved by the Bankruptcy Court on June 9, 1997. While the Bankruptcy Court has exclusive jurisdiction over a debtor's plan of reorganization, that jurisdiction does not include the right to approve a change in rates for a debtor utility whose rates are subject to regulation. Rather, the Bankruptcy Code, 11 U.S.C. §1129(a)(6), requires a debtor utility to obtain all necessary rate approvals from the appropriate regulatory agencies as a condition for final approval of a reorganization plan that includes a change in rates.

DISCUSSION OF ISSUES

Unforeseen Cost Issue

The Big Rivers' tariffs for service to Alcan and Southwire, which are to remain in effect for 12-13 years, specified that the Smelter rates contained therein would not be adjusted to reflect any cost or payment incurred by Big Rivers or the member distribution cooperatives for any expenditures due to legislation, regulatory action, legal action, or due to any other reason, whether foreseeable or unforeseeable (commonly known as the unforeseen cost issue).⁷ This tariff provision was premised on the assumption that there would be no major changes in environmental law or regulation during the remaining term of the Smelter contracts, which extend to 2010 for Southwire and 2011 for Alcan.⁸

Contrary to this assumption, on October 10, 1997, the U. S. Environmental Protection Agency ("EPA") issued a notice of proposed rulemaking which would significantly reduce the existing emission levels for nitrogen oxide (NOx). The emission reductions, if implemented, have the potential to significantly increase Big Rivers' capital and operating costs such that wholesale rate increases would be necessary. This tariff provision became the focus of extensive cross-examination during the November 1997 hearing. Numerous questions were raised concerning the financial ability of Big Rivers to absorb this or any other unforeseen costs without increasing rates and whether

⁷ First Revised Exhibit 3(b), filed September 25, 1997, Item 9, at 48, 76, and 77 of 115. The tariffs referenced the following examples of such action: carbon tax, BTU tax, CO₂ emissions reduction, or any other environmental or energy tax, charge, or liability.

⁸ Transcript of Evidence ("T.E."), Volume I, November 18, 1997, at 100.

exempting the Smelters from paying an appropriate share of unforeseen costs would obligate all other customers to pay the Smelters' share. At the conclusion of the November 1997 hearing, the Commission stated that the absence of a resolution of the unforeseen cost issue was a serious deficiency and suggested that the affected parties attempt to negotiate a mechanism to allocate future unforeseen costs in an equitable manner to each class of ratepayers.⁹

Big Rivers and the LG&E Parties notified the Commission on January 27, 1998 that a resolution of the unforeseen cost issue had been agreed to by some of the parties¹⁰ and a term sheet for the resolution was submitted on February 3, 1998. In summary, the unforeseen cost resolution includes the following provisions:

- 1) LEM will supply directly to Henderson Union and Green River the wholesale power needed to serve Alcan and Southwire, with LEM assuming all the risks for the Smelter loads.
- 2) Big Rivers will continue to supply wholesale power to Henderson Union and Green River for their non-smelter loads, as well as the total loads of Jackson Purchase and Meade County.

⁹ T.E., Volume V, November 24, 1997, at 235-236.

¹⁰ The parties agreeing to the Resolution were Big Rivers, the LG&E Parties, Alcan, Southwire, Green River, Henderson Union, and Meade County.

- 3) LEM will pay directly to RUS, on the behalf of Big Rivers, the level of Smelter net margins originally included in Big Rivers' financial models.¹¹
- 4) Big Rivers and LEM agreed to a number of changes concerning the financing of all future capital improvements envisioned for the Big Rivers' generating facilities.
- 5) Revisions were made to the RUS mortgage which provide Big Rivers a financing source for its share of future capital improvements.¹²
- 6) The use of arbitrage sale proceeds was revised, which would allow Big Rivers to make additional payments on its RUS mortgage as well as the RUS asset residual value note ("ARVP").
- 7) Big Rivers will pay to LEM \$1.85 million per year over the 25-year lease. The Smelters will pay to LEM an additional .5 mills per KWH on Tier 1 and Tier 2 power purchased.
- 8) Big Rivers was required by RUS to make additional up-front payments on its mortgage, and Big Rivers and LEM agreed

¹¹ The original Big Rivers' financial model was provided in the Application as Appendix L. While revisions to the financial model have been prepared and submitted, all versions are based on the version contained in Appendix L. These subsequent revisions have been identified as "MH-5A," "MH-5B," "SUP-11," and "SUP-16."

¹² Referred to in the record as the "clawback" provision.

to a financing arrangement which would allow Big Rivers to make the additional payments.

Big Rivers, the LG&E Parties, Alcan, Southwire, and Chase all expressed support for the unforeseen cost resolution.¹³ Big Rivers stated that the resolution addressed the Commission's concerns regarding how Big Rivers would meet future unforeseen costs, including the possible impact of the EPA's NOx proposal, without the subsidization of the Smelters by non-Smelter customers.¹⁴ The LG&E Parties noted that the resolution changes Big Rivers' initial funding responsibilities for capital expenses and allows it additional funds and increases its financial flexibility in the early years of the transaction.¹⁵ Alcan and Southwire argue that the resolution should be given a chance to close since it has the potential to finally resolve the difficult Big Rivers' situation in a manner that is fair to all customer classes and creditors.¹⁶ Chase contends that the resolution provides significant benefits to Big Rivers and its non-Smelter customers, in that Big Rivers is protected from credit risks associated with the Smelters, Big Rivers and its other customers are shielded from unforeseen costs attributable to the Smelters' load, and all customers will enjoy the same rates they were to receive under the Reorganization Plan.¹⁷

¹³ The Bank of New York filed a statement on March 30, 1998 concurring with the statements filed by Chase, but did not file a separate brief.

¹⁴ Big Rivers Supplemental Initial Brief at 4.

¹⁵ LG&E Parties Initial Brief Addressing Future Unforeseen Cost Issue at 14-15.

¹⁶ Alcan and Southwire Supplemental Brief on Unforeseen Cost Resolution at 15.

¹⁷ Chase Brief Concerning "Unforeseen Costs" Issue at 3.

Willamette did not oppose the unforeseen cost resolution, noting that it was more fair and reasonable than Big Rivers' original proposal.¹⁸ However, Willamette expressed its concern that the customers remaining with Big Rivers would have to bear the annual \$1.85 million payment to LEM, either directly through the cost of electric power or indirectly by other revenue that would otherwise be dedicated to offsetting costs borne by Big Rivers' customers.¹⁹

The AG opposed the unforeseen cost resolution, contending that the filing was incomplete and the record lacked sufficient evidence upon which to base a decision.²⁰ The AG further argued against the resolution because it would cause Big Rivers to incur additional expenses to maintain the Smelters' fixed rates and negate the Smelters' contribution to the debt payments, all to the detriment of the other customers.²¹ The AG also claims that the resolution will cause Big Rivers, Green River, and Henderson Union to be in violation of KRS 279.095 because they will no longer be operated for the mutual benefit of their members.²²

In support of the unforeseen cost resolution, Big Rivers prepared an economic analysis which compared the cash flows generated in its financial model under two scenarios. The first financial model, identified as MH-5A, included no expenditures for

¹⁸ Willamette Initial Brief on the Unforeseen Cost Issue at 1.

¹⁹ Id. at 6.

²⁰ AG Initial Brief on the Unforeseen Cost Resolution at 2.

²¹ Id. at 7.

²² Id. at 8-10.

unforeseen costs; while the second, identified as SUP-11, reflected the \$1.85 million annual payments.²³ The comparison revealed that, over the 25-year term, SUP-11 showed a cumulative decrease in cash flow of \$130.3 million on a nominal basis and a negative \$18.5 million cumulative net present value when compared to MH-5A.²⁴ In each year of the analysis, the ending cash balance was positive, but at lower levels in SUP-11 than in MH-5A. However, arbitrage sales were not modeled in either MH-5A or SUP-11.

In evaluating the reasonableness of the unforeseen cost resolution, the Commission has considered all of the arguments put forth by the parties and the economic analysis prepared by Big Rivers. In addition, the Commission has considered the potential impact that arbitrage sales would have on the economic analysis which compared the financial models MH-5A and SUP-11. Arbitrage sales are defined in the Reorganization Plan as all net revenues received in any particular calendar year resulting from one of three types of transactions. The first reflects the net benefit of purchasing power from third parties instead of purchasing such power from LEM during off-peak periods. The second reflects the net benefit of selling equivalent amounts of power using purchases from LEM during peak periods. The third reflects the net revenues of any new off-system power sales in excess of net revenues currently

²³ MH-5A is a version of the Appendix L financial model updated before the November 1997 hearing, prior to the parties addressing the unforeseen cost issue. SUP-11 is based on MH-5A, but reflects the impact of the Resolution, and was filed on February 23, 1998, as part of the Robison, Schaefer, and Hite Supplemental Testimony.

²⁴ Response to the Commission's March 10, 1998 Order, Item 1, page 4 of 16.

projected for such sales.²⁵ Originally, the net revenues from arbitrage sales were to be allocated 50 percent to Big Rivers and 50 percent as a payment on the RUS ARVP. As part of the unforeseen cost resolution, the allocation was changed to one third to Big Rivers, one third as payment on the RUS mortgage, and one third as payment on the ARVP. The Commission believes that arbitrage sales were an important benefit originally to Big Rivers' Reorganization Plan and that the unforeseen cost resolution's changes to arbitrage sales have increased that benefit.

The Commission finds that the unforeseen cost resolution is reasonable and addresses the concerns expressed at the November 24, 1997 hearing. The change in the way capital expenditures are financed, the adjustment in the allocation of operation and maintenance costs, the availability of financing resources for Big Rivers in the event additional unforeseen capital expenditures arise, the guarantee of the Smelter margins, and the revisions to arbitrage sale proceeds are all improvements to the overall transaction. The benefits of these improvements outweigh any detriments of the additional expenses for Big Rivers. While the ending cash flow is lower with the unforeseen cost resolution than without it, such a comparison is inappropriate. The financial model without the resolution included no expenditures for unforeseen costs, although Big Rivers was at risk for all such costs. The financial model with the resolution transfers that previously unquantifiable risk to the LG&E Parties for a known cost. The unforeseen cost issue has thus been resolved in a manner which produces

²⁵ Application Appendix C, page 35 of 121, First Amended Plan of Reorganization. The current projections for off-system sales are incorporated into the financial model, beginning in 2011.

significant additional benefits for non-Smelter customers without changing non-Smelter rates and is consistent with the cooperatives' obligations under KRS 279.095. Therefore, based on the representations and concepts expressed in the documents filed on or before February 27, 1998, the Commission approves in principle the unforeseen cost resolution.

Market Power Purchases

A central feature of Big Rivers' application is the proposal to allow Alcan, Southwire, and certain Large Industrial Customers the option of acquiring a portion of their power needs from third-party suppliers of their choice, no earlier than January 1, 2001.²⁶ This option is incorporated into the proposed Smelter tariffs as "Tier 3" and in the proposed Large Industrial Customer tariffs as "Market Power Purchases."

Smelters' Tier 3 Purchases. The interim tariffs permitted to go into effect on September 2, 1997 created three rate levels for Alcan and Southwire: Tier 1, Tier 2, and Tier 3. Under the interim tariffs, the maximum demand available under Tier 1 and Tier 2 energy is 233,000 KW for Alcan and 339,000 KW for Southwire, at a 98 percent load factor for each Smelter. Any demand in excess of these levels qualifies for purchase under Tier 3. The Smelter tariffs are structured as energy only rates which include the fixed costs typically recovered through a demand charge. The Tier 1 energy volumes

²⁶ This option was part of the original application, as well as a component of the Resolution.

constitute the Smelters' minimum purchase obligation²⁷ and the payment of the Tier 1 energy charges constitute their respective take-or-pay obligations to Big Rivers. The energy rates for Tier 1, Tier 2, and Tier 3 are fixed under the interim tariffs, and a separate transmission rate is included for Tier 3 energy only.²⁸

Under the proposed tariffs,²⁹ the three tier rate structure is retained, with LEM supplying power directly to Henderson Union and Green River for consumption by the Smelters. The demand and energy levels are essentially the same as those in the interim tariffs. The rates for Tier 1 and Tier 2 energy are the same as in the interim tariff, with the exception of the additional .5 mill per KWH payment to LEM to resolve the unforeseen cost issue. Two changes occur on January 1, 2001. First, the Tier 2 energy rate, which had been fixed, will be subject to change annually in accordance with a schedule incorporated into the tariff. Second, the Tier 3 energy rate, which had also been fixed at the same rate as in the interim tariff, is terminated and LEM has no further

²⁷ Alcan's minimum purchase obligation, Tier 1, is calculated by multiplying 2,304,960 KWH by the number of days in the billing month; the Tier 2 purchase allowance is the difference between the minimum purchase obligation and the amount calculated by multiplying 5,480,160 KWH by the number of days in the billing month. For Southwire, the minimum purchase obligation is based on 3,045,840 KWH and the Tier 2 purchase allowance is based on 7,973,280 KWH. See Second Revised Exhibit 3(a), filed August 22, 1997, pages 26, 27, and 36 of 52.

²⁸ The Tier 1 energy rate is \$.0307 per KWH; Tier 2 is \$.02098 per KWH; and the total Tier 3 rate, excluding transmission, is \$.01958 per KWH. The Tier 3 transmission rate is \$.98 per KW per month of Tier 3 demand. See Second Revised Exhibit 3(a), filed August 22, 1997, pages 25, 26, 34, and 35 of 52.

²⁹ The reference "proposed tariffs" reflects the terms and conditions contained in the documents filed on February 27, 1998. Also, these proposed tariffs reflect the impact of the resolution, which the Commission has accepted in principle.

obligation to supply the Smelters power in excess of the Tier 1 and Tier 2 volumes. All power consumed in excess of the Smelters' Tier 1 and Tier 2 maximum demands can be acquired from any power supplier at market-based rates. For these purchases the Smelters are to assume the responsibilities of identifying the third-party supplier, setting the terms of the transaction, calculating the amount of losses involved, and securing the transmission path.³⁰ The Smelters' respective distribution cooperatives, Green River or Henderson Union, would sign the actual contracts with the third-party supplier and purchase the power to supply the Smelters.

The AG opposed the Tier 3 market purchase provision, contending that wholesale market access for retail customers by contract is retail wheeling which is not authorized by the Territorial Boundary Act for electric service, KRS 278.016-278.018. The AG argues that the parties that negotiated Tier 3 have achieved electric deregulation and dictated its terms, without the benefit of legislative direction or oversight, for all incremental power used by the two largest retail electric customers in Kentucky. If Tier 3 is approved, the AG contends, it will establish a precedent which will encourage large power users served by other utilities to ask for similar or better treatment, and as a policy matter, such a precedent should not be established.³¹

Big Rivers, the LG&E Parties, Alcan, Southwire, and Chase disagreed with the bases for the AG's opposition and cited numerous arguments to support the market purchase option. They contend that the option is not retail wheeling, is not contrary to

³⁰ Response to the Commission's October 21, 1997 Order, Items 4 and 26.

³¹ AG Initial Brief at 7-10.

Kentucky law or public policy, need not await any legislative analysis of electric industry restructuring, and is not dissimilar to the right afforded to Gallatin Steel Company in 1995 to choose its wholesale power supplier. The market purchase option, they claim, is designed to reduce costs to the Smelters without raising costs for other customers,³² while the Reorganization Plan as a whole brings the benefits of competitively priced power to all customers.³³

Other Industrials' Market Power Purchases. Big Rivers proposed that three years after closing its Reorganization Plan certain Large Industrial Customers could acquire a portion of their power requirements under market-based conditions. To be eligible, a customer would have to have a peak demand of one MW or greater, sign a contract for a minimum term of five years, have a base contract demand of not less than 75 percent of its maximum contract demand, and have a minimum contractual monthly load factor of 70 percent.³⁴ Big Rivers estimated that six customers could be eligible for this market-based proposal.³⁵

The AG opposed this proposal, claiming it was an attempt to offer other industrial customers rates similar to the market purchase Tier 3 proposal for the Smelters. While agreeing that the proposal did not create the same contractual market access as the

³² Big Rivers Reply Brief at 8-9.

³³ LG&E Parties Initial Brief at 16.

³⁴ Revised Big Rivers Transaction Tariff, filed February 23, 1998, Item 29 at Original Sheet No. 37.

³⁵ Response to the Commission's August 12, 1997 Order, Item 29. The customers are Commonwealth Aluminum, Kimberly-Clark (Scott Paper), Willamette, World Source, A-CMI, and Wal-Mart Store No. 701.

Smelters would have, the AG argued that the proposal should be rejected because Big Rivers was giving up the right to serve a portion of its load, as well as the ability to earn a full contribution to fixed costs, for no apparent reason. The AG contends that there is no reason for a bankrupt utility to offer such a pricing option.³⁶

The LG&E Parties supported the proposal, noting that if market power is priced below Big Rivers' system power, industrial customers who accepted the market-priced option could achieve lower average prices by blending system-priced power with market-priced power.³⁷ Chase stated that, like the market purchase Tier 3 proposal, this proposal for large industrial customers did not violate the certified service territory statute.³⁸

Commission Analysis. Big Rivers has served its member distribution cooperatives for many years through a succession of full requirements contracts that have been required by the RUS to secure prior loan funds. As part of the negotiating process that led to the rates embodied in the Reorganization Plan, the RUS and other affected parties agreed to modify these full requirements contracts to accommodate the market power purchases for the Smelters and qualifying industrial customers. No similar accommodations have been forthcoming for any other customer.

The market purchase rate proposals constitute, at a minimum, the functional equivalent of retail wheeling for 8 out of 91,500 customers. If the electric industry in

³⁶ AG Initial Brief at 11.

³⁷ LG&E Parties Initial Brief at 14.

³⁸ Chase Initial Post-Hearing Brief at 4.

Kentucky is to be restructured to include retail wheeling, the Commission believes that such a restructuring should be undertaken voluntarily, in a reasoned and comprehensive manner which is designed to meet the overall needs of the Commonwealth and all its citizens, not just the specific needs of a single utility and a few large customers. Further, the Commission does not believe that electric restructuring can permanently be implemented on a case-by-case approach until a rigorous investigation of all aspects of the issue results in a determination that restructuring is in the public's best interest. Until that determination is made, proposals to offer 8 out of 91,500 customers the right to seek lower cost power through retail wheeling constitute unreasonable preferences in violation of KRS 278.170(1).

The existing regulatory scheme in Kentucky requires electric utilities to serve all customers within their certified territorial boundaries. For the Big Rivers' distribution cooperatives, this statutory obligation includes not only the distribution of electric energy to their customers, but also the selection and acquisition of an adequate source of supply to meet the foreseeable needs of their customers. The Commission does not believe that it has the authority to revise this statutory scheme to transfer, from the utility to a limited group of customers, the function of selecting a source of supply to meet those customers' needs. The market purchase options proposed here are dissimilar to the transaction approved in 1995 when East Kentucky Power Cooperative Corporation ("East Kentucky") lacked sufficient capacity to fulfill its contractual obligation to supply

Owen Electric Cooperative for service to Gallatin Steel Company.³⁹ The contracts and tariffs in that case indicate that East Kentucky fulfilled its contractual obligation by selecting the source of additional generating capacity, not by granting the retail customer the right to select the source of generation.

Therefore, the proposals to terminate the Tier 3 fixed rate after 2000 and to implement market purchase Tier 3 and the Market Power Purchase option for other industrial customers in three years are rejected. Green River and Henderson Union will be responsible for securing additional quantities of power for the Smelters after 2000. The cost for this power is unknown at this time and may result in future changes to the Tier 3 rate for the Smelters.

Revenue Decrease Allocation and Rate Design

For purposes of calculating the revenue impact of its proposed rates, Big Rivers utilized a test year ended December 31, 1996. Based on the rates in effect at the end of the test year, and various normalization adjustments to the actual demand and energy units billed during the test year, Big Rivers calculated its normalized test year revenues to be \$266,261,661.⁴⁰ Big Rivers calculated pro forma revenues of \$231,482,524, based on its proposed rates and several billing adjustments which reduce its billing demand from a normalized level of 14.4 million KW to a pro forma level of 13.4 million KW. The result is a decrease in revenues of \$34.8 million, or 13.06 percent.⁴¹

³⁹ Case No. 94-456, East Kentucky Power Cooperative, Inc.'s Filing of a Proposed Contract with Gallatin Steel Company.

⁴⁰ Application Exhibit 17, at 1, 5 and 6.

⁴¹ Id. at 1 and 8.

Based on Big Rivers' pro forma revenue analysis, the proposed rates produce the following decreases and average rates for Big Rivers' three customer groups:⁴²

<u>Customer Group</u>	<u>Existing Average Rates</u>	<u>Proposed Average Rate</u>	<u>Total Decrease</u>	<u>Percentage Decrease</u>
1. Smelters:	28.85 mills/KWH	24.7 mills/KWH	13.7 percent	\$20.2 million
2. Non-Smelter industrials:	34.60 mills/KWH	31.1 mills/KWH	12.8 percent	\$6 million
3. Rurals:	42.18 mills/KWH	37.2 mills/KWH	11.8 percent	\$8.6 million

The Commission finds that Big Rivers' comparison of its proposed rates to its existing rates is flawed. In determining customers' adjusted billing units, Big Rivers relied on its most recent Power Requirements Study to change the demand and energy billing units for several customers. For instance, Willamette's demand billing units were increased by 99,000 KW and its energy billing units were increased by 75 million KWH.⁴³ Big Rivers also included the impact of the market purchase option in calculating pro forma revenue. In determining the percentage rate decrease, Big Rivers compared pro forma revenue based on pro forma billing units to normalized revenue based on normalized billing units, thereby masking the true effect of the proposed rate change. The Commission believes that a more valid analysis would be one that compares customers' annual bills based on pro forma billing units at both Big Rivers' old base rates

⁴² "Existing Average Rate" and "Proposed Average Rate" derived from Application Exhibit 17 at 5-8; "Total Decrease" and "Percentage Decrease" from Application Exhibit 17 at 7-8.

⁴³ Application Exhibit 17 at 3 and 5.

and its proposed base rates.⁴⁴ Under such a comparison the average decrease for each customer group would be: Smelters - 18.0 percent; non-Smelter industrials - 12.3 percent; and Rurals - 9.2 percent.

Big Rivers presented a cost-of-service analysis which reflected both its pre-restructuring cost structure and its post-restructuring cost structure. The results of this analysis were consistent with the allocation of the proposed decrease amongst the customer classes.

AG Rate Issues. The AG objected to the proposed rates, focusing primarily on the rates offered to the Smelters. The AG urges rejection of the proposed Smelter rates and associated contracts because the Smelters are allowed to leave the Big Rivers system after 2011, their rates are fixed for the term of their current contracts, and their take-or-pay obligations are dramatically reduced.⁴⁵ Based on the AG's cost-of-service study, he also argues that the Tier 2 rates make no meaningful contribution to fixed costs, the Smelters make a smaller contribution to fixed costs than other classes, and the Smelters' rates are priced below their cost of service. The AG also argues that the proposed treatment of stranded costs and exit fees for the Smelters is unfair, unjust, and discriminatory.⁴⁶ Based on the results of his own cost-of-service study, the AG

⁴⁴ For this analysis, Big Rivers' proposed base rates for the Smelters include the agree upon .5 mills per KWH to resolve the unforeseen cost issue.

⁴⁵ Brown Kinloch Direct Testimony at 16-28.

⁴⁶ AG Initial Brief on the Unforeseen Cost Resolution at 10. In this brief, the AG notes that his original objections to the proposed Smelter rates now focus on Henderson Union and Green River, rather than Big Rivers, due to the impacts of the resolution of the unforeseen cost issue.

recommended rejection of the proposed rates for all customer classes and adoption of a \$5.36 per KW per month demand charge and a 19.58 mills per KWH energy charge for all customer classes and all sales.⁴⁷

Big Rivers noted that the proposed rates are an integral part of the Reorganization Plan and are supported by its cost-of-service study.⁴⁸ Big Rivers criticized the AG's cost-of-service study as flawed in its treatment of the purchased power costs from LEM and for proposing rates which resulted in disproportionate rate reductions favoring the rural customers at the expense of the Smelters.⁴⁹

Alcan and Southwire contend that the AG's cost-of-service study is flawed in assuming that purchased power costs were composed only of energy costs, omitting the lease and transmission payments as factors to be included, not considering the lower Smelter line losses, and allocating to the Smelters transmission costs below 161 KV.⁵⁰

The Commission finds the AG's arguments to be less than persuasive. Since the Smelters new contracts will expire at the same time as their old contracts, they are not being allowed to leave the Big Rivers' system. Resolution of the unforeseen cost issue, coupled with the fixed cost of wholesale power from LEM, justifies the prohibition of future rate adjustments, except as noted herein, attributable to wholesale but not retail cost changes. While the Smelters take-or-pay obligations have been reduced, Big Rivers

⁴⁷ Brown Kinloch Direct Testimony at 42.

⁴⁸ Big Rivers Reply Brief at 11-12.

⁴⁹ Id.

⁵⁰ Alcan and Southwire Main Brief at 15 and 20.

suffers no harm because LEM has agreed to guarantee the margins from Smelter sales at levels above the take-of-pay obligations.

In addition, the record demonstrates that the AG's cost-of-service study is flawed in assuming that purchase power costs are composed only of energy costs, by allocating costs of transmission facilities below 161 KV to the Smelters, and by omitting consideration of the lease and transmission payments and the lower Smelter line losses. These flaws undermine his proposed alternative rates. The AG has also failed to justify why his proposed class rate reductions are more reasonable than Big Rivers. The Commission also finds unacceptable the underlying premise in the AG's proposal which is the need for a rate increase in 2012 of 29 percent in the demand charge and 4 percent in the energy charge.⁵¹ Thus, the AG's rate proposals are not reasonable and will not be accepted.

Willamette Rate Issues. Willamette argues that the rates proposed for it are discriminatory, not based on cost of service, and are the result of negotiations that included neither itself nor a majority of the industrial customers. It contends that its decrease of 7.29 percent is not as large as that of some other customers in the large industrial class, its additional load has been ignored by Big Rivers, and it should be granted lower rates more in line with those of the Smelters given its status as the system's third largest customer with the third highest load factor. Willamette also argues that the impact of load factor on cost of service should be reflected in rates. In fact, Willamette argues that unless it signs a five year contract that puts 25 percent of its load

⁵¹ T.E., Volume V, November 24, 1997, at 227-228.

at market risk, it will receive a 1.5 percent rate increase.⁵² As an alternative to revised lower rates, Willamette proposed that all its load in excess of its current 55.5 MW level be eligible for the Market Power Purchase option.⁵³

Big Rivers disagreed with Willamette's arguments and rate proposals, noting that Willamette has different load and operating characteristics from the Smelters which justify a different classification of service. Big Rivers argues that Willamette will receive the overall rate reductions available to all non-Smelter industrial customers and will be eligible for the Market Power Purchase option.⁵⁴ Big Rivers' revenue comparison shows individual non-Smelter industrial customers experiencing annual bill reductions ranging from 1.51 percent to 26.83 percent, with a class average reduction of 12.82 percent.⁵⁵

The Commission finds Willamette's arguments to be unpersuasive. Willamette's analysis ignores the changes made by Big Rivers in developing its pro forma revenues and presents its arguments regarding the proposed increase based on the same flawed comparison used by Big Rivers. When customers' annual bills based on pro forma billing units at both Big Rivers' old base rates and its proposed base rates are compared, Willamette's proposed decrease will be 12.8 percent while the non-Smelter industrial class has an average decrease of 12.3 percent. Thus, Big Rivers' proposed decrease for Willamette compares favorably with that of the non-Smelter industrial class as a

⁵² Willamette Initial Brief at 2 and 6.

⁵³ Biscopick Direct Testimony at 16-17.

⁵⁴ Big Rivers Reply Brief at 13-19.

⁵⁵ Application Exhibit 17, page 7.

whole and, therefore Willamette suffers no undue discrimination by Big Rivers' rate proposal. In addition, Willamette has not demonstrated and the Commission finds no basis to believe that Willamette's proposal will generate the revenue levels needed by Big Rivers under the Reorganization Plan. The Commission further finds that Big Rivers' proposal does not unfairly single out Willamette for a lesser rate decrease than other customers within its class. Therefore, Willamette's rate proposals are denied.

Large Industrial Customer Rates Having rejected the Market Power Purchase option, the Commission finds it necessary to develop a schedule of rates for the large industrial class that will generate over the next 25 years the same approximate revenue stream as the rates proposed by Big Rivers. The Commission also finds merit in the argument raised by Willamette that differences in customers' load factors affect a utility's cost of service and such differences should be reflected in rates.

A simple approach to developing a new rate schedule for the non-smelter industrials would be to retain the \$7.37 demand charge proposed by Big Rivers and then calculate the energy charge necessary to generate the additional required revenues. However, a demand charge that is substantially lower than the previous charge of \$10.15 per KW necessitates an energy charge that would be significantly higher than the previous energy charge. Such a high energy charge, coupled with the impact of eliminating the Market Power Purchase option, would have a detrimental impact on high load factor customers because they would pay revenues markedly in excess of those produced by Big Rivers' proposed rates.

A rate design with a higher demand charge and corresponding lower energy charge will minimize such impact for the higher load factor customers that would have been eligible for the Market Purchase option. Therefore, the rates for the non-smelter industrial class will retain the \$10.15 demand charge that had been in effect prior to the interim rates and the entire decrease will be achieved through a reduction in the energy charge. The result is an energy charge of 13.715 mills per KWH for all energy sold. This energy charge is appropriate because, as Big Rivers pointed out, its post-restructuring variable costs of 18.44 mills per KWH as per its cost-of-service analysis are somewhat artificial because of the energy-only pricing structure contained in the power purchase agreement with LEM.⁵⁶ Had that pricing structure included separate demand and energy components, Big Rivers' cost of service would reflect much lower variable costs.⁵⁷ A comparison of the results of the Commission-developed rates to the results of Big Rivers' old rates using the pro forma billing units reflects an average decrease of 11.64 percent for the non-smelter industrial class with a 12.58 percent decrease for Willamette. Willamette will continue to have among the lowest rates on the Big Rivers system. Based on these factors, the Commission is satisfied that its rate design is fair, just, and reasonable for all customers in the non-smelter industrial class and should be adopted.

Smelter Tariff Provisions. The AG objected to two provisions in the Henderson Union and Green River Smelter tariffs. One provision would prohibit any adjustment to

⁵⁶ Application Exhibit 11 at 48.

⁵⁷ Id. at 49.

rates to reflect cost or payment incurred by Big Rivers or the cooperatives for any expenditures incurred due to legislation, regulatory, or legal action. The AG argues such a provision attempts to divest the Commission of its authority to change rates.⁵⁸ The other provision would allow the Smelters to avoid the payment of stranded costs or exit fees. The AG argues that the issue of stranded costs and exit fees will be a subject for electric industry deregulation, and that such a prohibition infringes upon the legislative prerogative, and unduly favors the Smelters.⁵⁹

Big Rivers countered that under the terms of the Reorganization Plan, there should be no stranded costs or exit fees for anyone on the Big Rivers system to pay.⁶⁰ The LG&E Parties contend that the proposed resolution of the unforeseen cost issue eliminates any concerns that non-smelter customers would be at risk for future unforeseen costs related to the Smelter load.⁶¹ Alcan and Southwire stated their belief that all stranded cost issues have been dealt with in the Reorganization Plan.⁶²

For Big Rivers, the Commission finds that the lease transaction, coupled with the unforeseen cost resolution, will minimize any risk that non-Smelter customers would be allocated the Smelters' share of costs resulting from legislative, regulatory, or legal changes. Similarly, this transaction will minimize the risk of stranded costs or exit fees

⁵⁸ AG Initial Brief at 3.

⁵⁹ Id. at 12.

⁶⁰ Big Rivers Initial Brief at 23.

⁶¹ LG&E Parties Initial Brief Addressing Future Unforeseen Cost Issue at 17.

⁶² Alcan and Southwire Supplemental Brief on Unforeseen Cost Resolution at 9.

allocable to the Smelters at the wholesale level. Thus, these provisions do not appear to be unreasonable for application to Big Rivers' wholesale costs.

However, the Commission finds that the same situation does not exist at the retail level. It is impossible to predict the cost changes that could occur over the next 13 years for Henderson Union and Green River and there is no agreement, analogous to the unforeseen cost resolution, to provide indemnification for changes in retail costs allocable to the Smelters. Neither the prohibition for cost adjustments due to legislative, regulatory, or legal action nor the prohibition of stranded costs or exit fees are reasonable at the distribution level and it is unreasonable to include these provisions in the distribution cooperative tariffs and contracts with the Smelters.

Other Transaction Issues

Lease of Generating Units. Big Rivers has proposed to lease, for a term of 25 years, all its generating units to WKEC while having a 25 year right to purchase power, within established minimum and maximum quantities, from LEM. The lease transaction is the centerpiece of the Reorganization Plan and it enables Big Rivers to divest itself of its generating capacity while purchasing only the quantities of power projected to be needed over the 25 year term. The Commission finds that the proposed lease transaction does constitute a change in control within the parameters of KRS 278.020(4) and 278.020(5) and is subject to our jurisdiction. Based on a review of the record and the lease transaction as evidenced by the documents on file as of February 27, 1998, the Commission finds that WKEC has the financial, managerial, and technical expertise to operate Big Rivers' generating units and the transfer is in accordance with law, for a

proper purpose and is consistent with the public interest. Therefore, the Commission will approve the lease transaction in principle, subject to verification that the final transaction documents do not materially change the transaction as reviewed in this case.

In addition, the Commission finds that the proposed accounting treatment for the lease transaction is in accordance with generally accepted accounting principles and the Commission concurs with that treatment. Big Rivers should provide the Commission with the accounting entries made to record the lease transaction within 10 days of their entry on the books of Big Rivers.

Transmission Service and Interconnection Agreement. The Applicants requested approval of the Transmission Service and Interconnection Agreement, as well as Big Rivers' Open Access Transmission Tariff, which will be filed at FERC. The Commission finds that, to the extent these documents are subject to our jurisdiction, they are reasonable and should be approved in principle subject to review of the final draft agreements to verify that there have been no material changes.

Evidences of Indebtedness. Big Rivers and the LG&E Parties have requested the Commission's approval for Big Rivers to issue evidences of indebtedness as contained in several of the transaction documents.⁶³ These financings are an integral part of the Reorganization Plan and are necessary to implement the debt restructuring and lease

⁶³ The documents in question are the Cost Sharing Agreement; the Lease and Operating Agreement; the Mortgage and Security Agreement; the agreement with new credit providers AMBAC and Credit Suisse First Boston, relating to the Pollution Control Bonds, to the extent required; and the security instruments evidencing liens given to LEM under the terms of the revised Participation Agreement.

transaction. The Commission finds that the proposed financing is for a lawful object within Big Rivers' corporate purpose, is necessary and appropriate for the proper performance of its wholesale electric service to the public and will not impair its ability to perform that service, and is reasonably necessary and appropriate for such purpose.

Station Two Subsidiary. Big Rivers and the LG&E Parties requested that the Commission approve Big Rivers' transfer to the Station Two Subsidiary of certain obligations with respect to HMP&L's Station Two facility. In addition, the LG&E Parties requested that the Commission declare the Station Two Subsidiary to be a jurisdictional utility because KRS 96.520 limits a municipal utility to selling excess power either out of state or to a Commission-regulated utility.

The Commission finds that the transfer of HMP&L Station Two facility obligations to the Station Two Subsidiary is reasonable and will be approved. At the March 18, 1998 hearing, the LG&E Parties stated that legislation was pending in the 1998 Regular Session of the Kentucky General Assembly which would eliminate the need to declare the Station Two Subsidiary to be a jurisdictional utility. This legislation has since been approved by the General Assembly and signed by the Governor.⁶⁴ Therefore, the request to declare the Station Two Subsidiary a jurisdictional utility is denied as moot.

EWG Status. Big Rivers and the LG&E Parties requested that the Commission declare each of Big Rivers' generating facilities to be an "eligible facility" within the meaning of Section 32(a)(2) of PUHCA. This finding is a prerequisite for WKEC to be

⁶⁴ Senate Bill 269 was passed by the Senate on February 27, 1998, the House of Representatives on March 23, 1998, and was signed by the Governor on April 1, 1998.

declared an exempt wholesale generator by FERC and thereby exempt from all provisions of PUHCA.

After examining the evidence, the Commission finds that the generating facilities of Big Rivers have been used for the generation of electric energy exclusively for sale at wholesale. The Commission further finds that allowing the Big Rivers generating facilities to be eligible facilities will benefit consumers by allowing Big Rivers to consummate its Reorganization Plan which includes the lease transaction, is in the public interest, and does not violate Kentucky law. At the request of the LG&E Parties, the Commission will condition this grant of eligible facility status upon the closure of the transaction between Big Rivers and the LG&E Parties.

Wholesale Power Contracts. Big Rivers and the LG&E Parties requested that the Commission approve the amendments to the wholesale power contracts with the member distribution cooperatives. As with other transaction documents, the Commission finds that these contracts as filed by February 27, 1998, should be approved in principle, subject to deletion of the Smelters' exemptions from distribution level cost changes due to legislative, regulatory, or legal action or distribution level stranded costs and exit fees. The final drafts of these contracts will be reviewed as part of the new proceeding to ensure that appropriate changes have been made to reflect the decisions herein and that no other material changes have been made.

Consolidation of Pending Fuel-Related Cases

In its Application, Big Rivers requested that this case be consolidated with two fuel-related cases currently pending at the Commission. This request was subsequently

expanded when Big Rivers filed its initial brief on February 13, 1998 to include additional fuel adjustment clause ("FAC") proceedings covering November 1, 1990 through April 30, 1994 which were remanded to the Commission in January 1998. Big Rivers argues that consolidation of these proceedings with the case at bar and the Commission's approval of the rates set forth in Big Rivers' Plan of Reorganization will render those cases moot.

As a result of an extensive investigation into Big Rivers' fuel procurement practices, the Commission on July 21, 1994, in Case No. 90-360-C,⁶⁵ found that Big Rivers had incurred unreasonable fuel costs as a result of its decisions to enter certain coal supply contracts and required Big Rivers to amortize and credit those costs to its customers. Based upon the record developed in Case No. 90-360-C, the Commission in subsequent FAC review proceedings⁶⁶ ordered Big Rivers to make additional credits to its customers.

⁶⁵ Case No. 90-360-C, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation from November 1, 1990 to April 30, 1993.

⁶⁶ Case No. 92-490-B, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation from May 1, 1993 to October 31, 1993 (August 9, 1994); Case No. 92-490-C, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation from November 1, 1993 to April 30, 1994 (November 1, 1994); Case No. 94-458, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation from November 1, 1992 to October 31, 1994 (March 5, 1996); Case No. 94-458-A, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation from November 1, 1994 to April 30, 1995 (June 19, 1996); Case No. 94-458-B, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation from May 1, 1995 to October 31, 1995 (July 9, 1996); Case No. 94-458-C, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation from November 1, 1995 to April 30, 1996 (October 16, 1996).

As a result of judicial reviews filed by Big Rivers and the Smelters, the Franklin Circuit Court affirmed the Commission's July 21, 1994 Order to disallow the unreasonable fuel costs, but remanded the matter to the Commission to determine whether two fuel contracts complied with the FAC regulation and whether the fuel costs associated with those contracts were prudent or the result of improper fuel procurement practices.⁶⁷ The Court further directed the Commission to determine, if appropriate, the amount of any additional refunds.

The Commission and Big Rivers appealed the Franklin Circuit Court ruling. Finding that the Franklin Circuit Court's judgment was not final, the Kentucky Court of Appeals on July 3, 1997 dismissed these appeals.⁶⁸ On January 14, 1998, the Kentucky Supreme Court denied the Commission's Motion for Discretionary Review.⁶⁹ As a result, these cases are again before the Commission.⁷⁰

Having considered Big Rivers' request for consolidation, the Commission denies it. As the request relates to the remanded proceedings, it was not properly raised. The proceedings involving Big Rivers' FACs were not remanded to the Commission until

⁶⁷ Big Rivers Electric Corp. v. Pub. Serv. Com'n, No. 94-CI-01184, slip op. at 14 (Franklin Cir. Ct. Oct. 20, 1995).

⁶⁸ Pub. Serv. Com'n v. Big Rivers Electric Corp., No. 95-CA-3079-MR, slip op. at 2-3 (Ky. Ct. App. July 3, 1997).

⁶⁹ Pub. Serv. Com'n v. Big Rivers Electric Corp., No. 97-SC-610-D (Ky. Jan. 14, 1998).

⁷⁰ Not all of the Orders have been remanded to the Commission. Actions for review of Commission Orders in Cases No. 94-458, 94-458-A, 94-458-B, and 94-458-C are still pending before Franklin Circuit Court and have not been remanded to the Commission.

January 14, 1998. The issue was not before the Commission when the principal hearing in this matter was held and was raised for the first time in Big Rivers' initial brief.⁷¹ The parties have not had an adequate opportunity to address the issue.⁷²

Moreover, consolidation of the fuel cases into this proceeding is inconsistent with the express directives of the Franklin Circuit Court judgment. The Court directed the Commission to make certain determinations regarding two fuel contracts and the fuel costs incurred under those contracts. Consolidation will not advance this objective but impede it. Under Big Rivers' proposed approach, the Commission would consolidate the cases into this proceeding and then take no further action.

The Commission is not the appropriate forum to address Big Rivers' argument that the Bankruptcy Court's approval of the Plan of Reorganization extinguishes any right of ratepayers to pursue refunds and renders the Franklin Circuit Court judgment moot. That forum is the Franklin Circuit Court. As the matter currently stands, Franklin Circuit Court has directed the Commission to take certain actions. Its judgment has not been modified, suspended or revoked. No court of superior jurisdiction has relieved the Commission of its obligations under the judgment. Absent such court action, the Commission must comply with the judgment and make the required determinations. Given the voluminous record and complex issues in the remanded cases, those

⁷¹ Big Rivers Initial Brief at 25-33.

⁷² For that matter, Big Rivers failed to provide notice of its request to all parties in Case No. 90-360-C. The record fails to reflect that any notice of the consolidation proposal was given to Prestige Coal Company.

determinations should be made in a separate proceeding and not be consolidated with this proceeding.

Depreciation Study

Big Rivers disclosed during the proceeding that the required accounting for the lease transaction might result in the book value of Wilson being overstated, and that there might have to be an asset book value write down. However, before Big Rivers could finalize its determination of the need for a write down, it had initiated a new depreciation study, which has not yet been completed.

The Commission finds that within 30 days of Big Rivers' completion and acceptance of a new depreciation study, a copy should be filed with the Commission. No changes in depreciation rates should be implemented under that study until the Commission has reviewed the new study. Big Rivers should also promptly inform the Commission of its determination regarding the need for an asset book value write down and, if one is determined to be necessary, initiate the appropriate proceeding.

Debt Service Plan

The AG objected to the debt service schedule contained in Big Rivers' financial model, contending that it was back loaded. The AG argued that only 36 percent of the principal on the RUS debt will be paid by the time the Smelters are expected to leave the Big Rivers system.⁷³ The AG notes that under the unforeseen cost issue resolution,

⁷³ AG Initial Brief at 18.

more of the debt service is shifted to the later years of the transaction, when only the non-Smelter ratepayers are still on the system.⁷⁴

The Smelters argued that the AG's statement about the 36 percent figure is true, but completely misleading because debt service is not measured only by the repayment of principal, but by the sum of principal and interest. The Smelters stated that the projected debt service schedule, agreed to by the lenders, represents a largely levelized combination of interest and debt principal payments.⁷⁵

The Commission has reviewed the arguments and concludes that the AG's analysis has not taken into consideration the entire scope of the impact of the transaction, as modified by the unforeseen cost resolution. The AG's argument fails to consider the fact that the repayments to RUS must equal a pre-determined present value, regardless of the timing of principal and interest payments. This arrangement allows Big Rivers a degree of flexibility during the early years of the transaction. In addition, the AG does not appear to have considered the impact of LEM's lease payments or the potential impact of arbitrage sales on the outstanding debt. Concerning the impact of the unforeseen cost resolution, Big Rivers apparently had no loan sources to fund the up-front capital expenditures as envisioned in the original plan. While the resolution did result in a shift of the debt service schedule, it also provided Big Rivers with a needed source of financing for its reduced capital expenditures responsibilities. Therefore, while the situation identified by the AG is an important consideration, taken in light of the overall benefits and provisions of the transaction as modified, the

⁷⁴ AG Initial Brief on the Unforeseen Cost Resolution at 2.

⁷⁵ Alcan and Southwire Main Brief at 31.

Commission finds that the arguments of the AG do not justify the rejection of the proposed debt service schedule.

Monitoring and Reporting

The proposed transaction, as modified by the resolution of the unforeseen cost issue, contains what the Commission believes to be a valuable incentive to Big Rivers: the ability to make arbitrage sales and Other Sales.⁷⁶ Big Rivers has placed a significant amount of reliance on its ability to make Other Sales and the revenues to be generated by those sales will be critical to its long-term financial restructuring.⁷⁷ To encourage Big Rivers to utilize this option to its greatest potential, and to ensure that the Commission is timely informed of Big Rivers' progress in making both arbitrage sales and Other Sales, the Commission will require Big Rivers to:

- Develop and file with the Commission within 60 days of the Transaction Closing Date, a strategic plan concerning arbitrage sales;
- Develop and file with the Commission within 30 days of the date of this Order, an interim sales plan, to be in effect until the strategic sales plan is implemented;
- File with the Commission within six months after the date of this Order, and every six months thereafter, a report on arbitrage sales and Other Sales; and

⁷⁶ Other Sales are off-system sales envisioned in Big Rivers' financial models to begin after the termination of the current Smelter contracts in 2011.

⁷⁷ From 2011 to 2022, Big Rivers forecasts annual gross sales revenues ranging from \$36.1 million to \$45.9 million, which represents 15 to 20 percent of all gross sales revenues during the period. See Robison, Schaefer, and Hite Supplemental Testimony, Exhibit SUP-11, lines 304 through 309. Percentage impact is determined by dividing line 307 by line 309 in any year after 2010.

- File with the Commission a report, appended to its annual report, comparing its actual cash flows for the calendar year with the amounts included in the SUP-11 financial model filed in this proceeding.⁷⁸

SUMMARY AND CONCLUSION

Throughout this proceeding the Applicants, the Smelters, and three distribution cooperatives have repeatedly stated that the proposed rates are an integral part of the Reorganization Plan, were the result of intense and extensive negotiations, and that any modifications could disrupt the carefully balanced interests of those who participated in the negotiations. Simultaneously, the AG and one distribution cooperative, Jackson Purchase, have vigorously opposed the proposed rates on the basis that the benefits of the reorganization have not been fairly distributed among all customer classes, resulting in unduly preferential rates for some customers. The Commission has taken all these statements into consideration and has made the findings and decisions set forth herein based on the evidence and the critical need for Big Rivers to emerge from bankruptcy as quickly as possible.

It has not been an easy task to balance all aspects of the transaction and the proposed rates with our statutory obligations under KRS Chapter 278. Our task was not made any easier by the inclusion of certain rate provisions which appeared to be the product of less than equal bargaining leverage among the parties to the Reorganization Plan. We recognize that there will need to be some changes to the transaction to

⁷⁸ The report will be based on lines 363 through 411 of SUP-11, and include explanations for any deviations from the SUP-11 figures in excess of 10 percent.

accommodate our findings. However, we do not believe that those changes will significantly alter either the purpose or the intent of the transaction.

From the perspectives of Big Rivers and its major creditors, our decisions should not reduce the cash flow reflected in Big Rivers' financial models, thus preserving Big Rivers' ability to meet its operating expenses and debt service payments. In addition, as a result of the resolution of the unforeseen cost issue, the margins that were projected to be earned on sales to the Smelters will now be guaranteed by LEM. Although we have denied the market power purchase option for large industrial customers, we have developed rates for this class which provide a reasonable rate reduction, generally between 7 to 12 percent based upon anticipated loads, without requiring the commitment to a five year contract. For the rural consumers, the rate reductions implemented in September 1997 will remain in effect. In addition, the resolution of the unforeseen cost issue should provide significant financial protections to the rural and large industrial customers from the risks of new regulatory, legal or environmental costs not associated with their load.

From the perspective of the Smelters, our decisions retain the fixed prices for Tier 1 and Tier 2 power which is critical to their ability to compete in the world-wide aluminum market. Although we have denied the Tier 3 market purchases for the Smelters' incremental power needs, our decision to allow LEM to supply the Smelters' Tier 1 and Tier 2 power provides an extra margin of reliability and allows Green River and Henderson Union to reduce their full-requirements relationship with Big Rivers. While we have rejected the Smelters' exemption from unforeseen costs and exit fees at the

distribution level, we have allowed such exemptions for any wholesale costs or fees attributable to Big Rivers. We truly believe that Big Rivers and the Smelters are vital to the economy of western Kentucky and their fortunes have been intertwined for many years. Even though our decisions today sever most of their existing ties, the Smelters' ability to purchase reasonably priced power at fixed costs from LEM is the result of the availability of valuable generating assets on the Big Rivers system.

Transaction Documentation Approval

The application, as filed on June 30, 1997, contained the supporting transaction documents which were incomplete or otherwise noted as being subject to further revision. Over the next five months, the Applicants filed revisions to the transaction documents and many were not finalized as of the November 1997 hearing. To accommodate the Applicants, the Commission established December 19, 1997 as the due date for final drafts of the documents and January 15, 1998 as the date to resolve the unforeseen cost issue.

Documents were not in final draft form by late December 1997. The Applicants subsequently requested, and the Commission granted, an extension to January 30, 1998 to resolve the unforeseen cost issue. On January 27, 1998, the Applicants and the Smelters filed a joint notice that the unforeseen cost issue had been resolved in principle, but not yet reduced to writing, and subsequently requested to indefinitely suspend the briefing schedule. The Commission, by Order dated January 29, 1998, denied the request, citing KRS 278.190(3) as limiting our rate jurisdiction to 10 months, which would expire on April 30, 1998.

A supplemental procedural schedule dated February 13, 1998 was adopted to investigate the unforeseen cost resolution and it established February 23, 1998 as the final date for all documents. The Applicants filed some documents by that date, but indicated that others were incomplete and would be filed later that week. The AG objected to this delay and, by Order dated February 26, 1998, the Commission extended the due date to February 27, 1998, but admonished the Applicants that any documents not filed by that date would not be considered in this case.

In contravention of the February 26, 1998 Order, the Applicants continued to file documents after the due date. Chase then objected, claiming a denial of due process, when the Applicants filed additional documents on March 19, 1998, after the supplemental public hearing.

The Commission well recognizes the importance of the pending transaction to Big Rivers' financial rehabilitation and the need to act as expeditiously as possible. However, the parties' due process rights must be respected and accommodated. In addition, the continual revisions to the transaction documents have frustrated the Commission's investigative efforts to the extent that we are no longer confident that the transaction contemplated by the Applicants is not materially different from the transaction reviewed at the March 18, 1998 hearing. Therefore, we will approve the transaction documents in principle as filed with the Commission on the due date of February 27, 1998.

To afford the parties and the Commission an opportunity to verify that no material changes have been made to the structure of the transaction, we will require the

Applicants to file as quickly as possible, but no later than May 29, 1998, final drafts of all transaction documents that have undergone any changes since February 27, 1998. The documents should be filed in a new docket with copies to all parties to this case. The scope of review will be limited to determining whether the final transaction documents have materially changed since those filed by February 27, 1998 and to review the changes necessitated by this Order. Each document filed should contain a clear identification of each change and be supported by a detailed explanation of the reason for the change. The review should take no more than 30 days and will include one round of discovery and an informal conference or hearing if necessary.

IT IS THEREFORE ORDERED that:

1. Based on the documents on file with the Commission as of February 27, 1998, the proposed transaction, as modified by the resolution of the unforeseen cost issue, is approved in principle, subject to the modifications contained in this Order.

2. The market power provision in the Smelters' Tier 3 rate and the Market Power Purchase option for certain Large Industrial Customers are hereby denied and the termination date on the Tier 3 fixed rate is rejected.

3. The rates for non-Smelter industrial customers are modified as discussed in this Order. The remaining rates proposed by Big Rivers and contained in the tariff draft bearing an issued date of February 23, 1998 are approved. All rates approved herein are effective for service rendered on and after the date of this Order.

4. The alternative rates proposed by the AG are hereby denied.

5. The alternative rate proposed by Willamette is hereby denied.

6. Provisions in the Smelters' tariffs and their contracts with the distribution cooperatives prohibiting rate adjustments to reflect costs or payments incurred by the distribution cooperatives for expenditures due to legislation, regulatory, or legal action are rejected.

7. Provisions in the Smelters' distribution cooperative contracts and tariffs exempting the Smelters from paying any stranded costs or exit fees relating to the distribution cooperatives are rejected.

8. The Applicants shall file, in a new case, the final drafts of the transaction documents supported by a clear identification of each change made and a detailed explanation of each change to the versions on file with the Commission as of February 27, 1998. The Applicants shall serve copies of all documents on the parties to this case, who shall be deemed parties to the new case.

9. The Transmission Service and Interconnection Agreement, and Big Rivers Open Access Transmission Tariff are approved in principle subject to review of the final drafts of the documents.

10. Evidences of indebtedness required of Big Rivers in conjunction with the transaction documents are approved in principle, subject to review of the final transaction documents.

11. The transfer of control of Big Rivers' generating units to WKEC and the transfer of the HMP&L Station Two facility obligations are hereby approved in principle, subject to review of the final version of the transaction documents.

12. Big Rivers' generating facilities are "eligible facilities" within the meaning of Section 32(a)(2) of PUHCA, subject to the closure of the transaction as contemplated by Big Rivers and the LG&E Parties.

13. Big Rivers shall file the accounting entries made to record the lease transaction within 10 days of entry into the books of Big Rivers.

14. The Wholesale Power Contracts between Big Rivers and the distribution cooperatives are approved in principle, subject to the revisions discussed in this Order and subject to the review of the final version of the contracts.

15. Big Rivers shall file a copy of the new depreciation study within 30 days of its completion and acceptance, and shall not implement any changes in depreciation rates recommended in that study until the Commission has reviewed the study.

16. Big Rivers shall not write down the book value of any generating station without prior Commission approval.

17. Within 30 days of the date of this Order, Big Rivers shall file its tariffs, reflecting all revisions and modifications as described in this Order.

18. Within 60 days of the transaction closing date, Big Rivers shall file a strategic plan for maximizing arbitrage sales.

19. Within 30 days of the date of this Order, Big Rivers shall file an interim sales plan, to be in effect until the strategic sales plan is implemented.

20. Within six months of the date of this Order, and every six months thereafter, Big Rivers shall file a report of arbitrage sales and Other Sales.

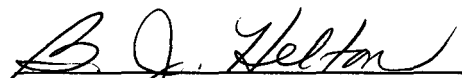
21. Big Rivers shall file a report, appended to its annual report, comparing its actual cash flows for the calendar year with the amounts included in the SUP-11 financial model filed in this proceeding. The report shall be based on lines 363 through 411 of SUP-11, and include explanations for any deviations from the SUP-11 amounts in excess of 10 percent.

22. The reports required herein shall initially be submitted by Big Rivers subject to further modifications as deemed necessary by the Commission, to allow for the monitoring of Big Rivers' compliance with the transaction and the findings of this Order.


Nothing contained herein shall be construed as a finding of value for any purpose or as a warranty on the part of the Commonwealth of Kentucky, or any agency thereof, as to the securities authorized herein.

Done at Frankfort, Kentucky, this 30th day of April, 1998.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director